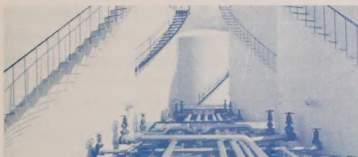
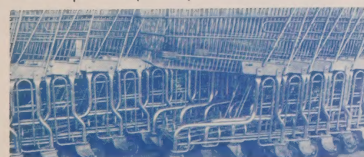


# the monitor

Centre for the Study of Inflation and Productivity

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## The post-controls message

There has rarely been a more delicate moment in Canadian economic management.

When Canada went into the regime of wage and price controls three years ago, the Consumer Price Index was rising at a year-over-year rate of about 10½% and unemployment was 7%.

Now as we emerge from the controls program, the CPI is still advancing at almost 9½% and unemployment has risen to 8½%.

Individual incomes—real, disposable incomes, after deducting inflation and taxes—have been badly squeezed. So have profits.

The temptation now facing all of us is to recoup these losses by raising our incomes.

By now that might have been possible if, during the controls program, we had managed to increase productivity by some significant amount. But we didn't. It was simply too difficult to make more efficient, more productive use of labour, equipment and plants when such a large proportion of those basic resources was idle due to weak demand.

How do we get out of this situation?

First, it is important to recognize that we have some economic forces working for us:

—Though the economy is not yet growing fast enough to take up the slack in either the workforce or industrial capacity, it is *growing* and there is some further growth in prospect.

—We have become substantially more competitive in both our export and domestic markets by holding down some of our costs (especially labour costs) and keeping the benefits of depreciation in the external value of the dollar.

—While dollar depreciation has also worked against the anti-inflation program (by raising the prices of imports), there has nonetheless been an *easing* of the basic inflationary pressure in the economy, and *it will continue if we let it continue*.

Now two things must happen at once:

1. We need more domestic demand—more consumer expenditure on goods and services—so the economy will grow, so we can take up the existing slack, so we can work toward increased productivity, so we can *earn* higher incomes.

Here there is a danger. While governments are restraining expenditure, we must guard against any combination of inflationary pressures and restrictive monetary and fiscal policies that would wring the real growth out of the economy.

2. We need restraint on incomes and prices.

Therein lies an even greater danger. If Canadians, generally, build the current high rate of CPI increase into their price and wage decisions, they will bring on another round of spiralling inflation. That in turn would feed into our cost structure, threaten our international competitiveness, and further undermine the value of the Canadian dollar.

We have been along that route before and it could lead back to controls.

# The centre: an exercise in economic suasion

The Centre for the Study of Inflation and Productivity is the fourth Canadian agency in 10 years to be mustered for the battle against inflation.

There was the Prices and Incomes Commission (1969-72). Then the Food Prices Review Board (1973-75). Then (and still) the Anti-inflation Board (1975- ).

As for the Centre:

- We are concerned with both inflation and productivity.
- We have been explicitly charged with the task of informing the public about the issues.
- We have no power to regulate, decree, set, or roll back incomes or prices.
- We prefer not to use numerical guidelines.
- We will use publicly available information in our analysis of any situation that we feel requires examination.
- We will ask others to volunteer information when that is necessary.
- We expect to see a few relatively large wage and price increases that are justifiable and necessary.
- We expect to see some that are not.
- We will respond quickly to spotlight behaviour that our analysis indicates as unreasonable.
- We will when necessary ask government to launch a special inquiry.

There are three other important features of the new Centre:

1. We are a national entity created at the request of the 11 senior Governments.
2. We are a unit within the Economic Council of Canada, an independent advisory body.
3. We have a two-year mandate.

But just what job? What is the objective of this exercise?

The First Ministers' Conference in February agreed: "that the Economic Council of Canada in addition to its present statutory functions be requested, if feasible, to assume the responsibility for analyzing price and cost developments for a limited post-control period. Its function would be to inform the public and draw public attention to cost or price developments which appear to threaten the national economic objectives. It would also have a research and educational role in the improvement of productivity."

The Council accepted the assignment, considered how the task could best be approached, and in June announced the establishment of the Centre.

In her announcement Dr. Sylvia Ostry, the Council Chairman, said in part:

"(The Centre's) basic thrust will be to use its analytical and educational capabilities to promote a better understanding of major issues concerning the nature and sources of inflation, productivity, and performance on the part of public and private decision-makers as well as the general public."

The Centre recruited its initial staff during the summer and began its

research and operations in August. Our staff will number about 75 and we expect total expenditures will approach \$6 million over the two years.

Three groups have been organized within the Centre:

*A Macroeconomic Analysis Division*, which will analyze short-term domestic and international developments, track movements in price and cost indexes, and explain how various events affect the objectives of stability and growth.

*A Sectoral and Structural Analysis Division*, which will analyze labour relations and compensation, the industrial structure of the economy, and inflation and productivity developments (including individual price and wage decisions) at the sectoral and industry levels.

*A Communications Division*, whose main job is to package and distribute the Centre's work in a way that will improve public understanding.

No claim is made by the Centre that it can suddenly invest economics with the clarity, simplicity and precision of language that has so successfully defied the subject for so many years.

Our goal is to make a significant contribution to public understanding.



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# The prospect for wages

The Canadian labour situation depends critically on what happens in the next 6 to 12 months. Did the AIB controls—or controls plus economic reality—establish a pattern of restraint? Do we risk a return to double-digit wage settlements?

The controls period brought a clear, consistent, progressive reduction in the rate of increase of the major indicators of labour cost in Canada. The downward trend has generally continued but with some worrisome exceptions. A pattern for wage settlements *outside* controls has not yet emerged; these have not yet found their way into the data available for analysis.

While wage and labour-cost data do not yet portray an upturn in the rate of increase, we are concerned—and we are not alone—that the current high level of price increases, largely due to food prices, will be translated into wage settlements that reactivate the underlying pressures on labour costs and prices.

A close look at the wage-determination process in Canada confirms everyone's suspicion that the level of prices and price *expectations* are telling factors in the outcome. If, in the coming months, the price increases due to the food price situation *and* to the depreciation of the Canadian dollar are built into long-term compensation settlements, Canada faces the distinct danger of a "wage bubble". If that happens, the Canadian industrial structure will begin to lose any competitive advantage that has been derived from depreciation and the steady decline in the inflationary pressures in the economy. High wage settlements that cause more price increases will cost all of us a future cut in income.

The Centre is also concerned that the more frequent use of cost-of-living allowance (COLA) clauses in wage contracts has made the Canadian cost and price structure overly sensitive to "shocks" in the international economy or factors such as the food price cycle. With COLA clauses, wages are "triggered" to increase automatically in response to rises in the Consumer Price Index (CPI), regardless of the cause. COLA clauses are designed to protect.

But they can and sometimes do work to make a bad situation worse; they can act to amplify and prolong the inflation problem created by an international shock.

This is not a case against the use of COLA clauses. But in an "open economy" like Canada's and several in Europe there is growing concern that wage indexation seriously complicates the problem of slowing the rate of price increases. Over the coming months the Centre will study this situation.

The next year is made even more critical by the unusually large number of contracts that will have to be negotiated. One consequence of the period of controls was that the average duration of contracts was shortened, so that a large number of contract renegotiations must now get under way in December 1978 and the initial months of 1979.

The Centre will be monitoring the labour situation closely in these coming months. We believe it would be a mistake, however, to apply some simple guideline that would flag settlements that are "too high". Such an approach does not recognize that different wage rate changes are necessary to compensate for high or low productivity gains, and to reflect high or low labour market demand for people who have particular skills and experience.

The *aggregate* labour-income indicators will, of course, be monitored

by the Centre. As well, we may "spotlight" some individual settlements that are difficult to explain on the basis of productivity gains or resource allocation. Some settlements may also be analyzed for particular features, such as COLA clauses.

## The view from October

The average increase in base-rate wages in major contracts declined from 17% in 1975 to 6.4% in the second quarter of 1978. For settlements without COLA clauses, the decline was even more dramatic: from 19.1% to 6.4% over the same period.

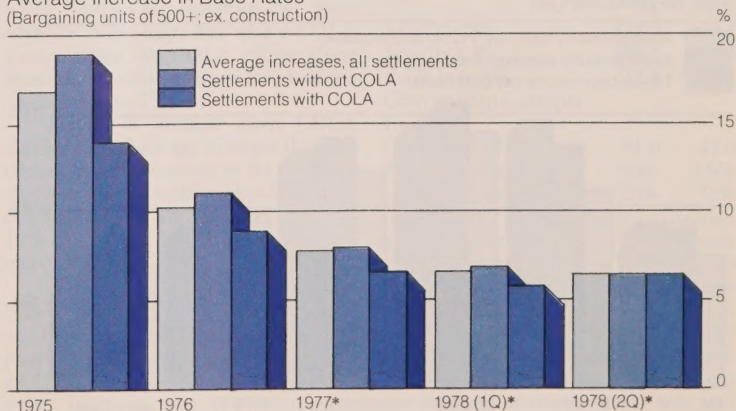
It is disturbing that in the second quarter of this year the average base-rate change for settlements *with* COLA clauses (6.4% excluding future COLA amounts) was identical to that for settlements *without* COLA clauses. Moreover, the second-quarter gain in contracts with COLA provisions exceeded the rate of increase in the first quarter. While a one-quarter increase for a subset of the new contracts does not constitute a trend, *this is one of the initial danger signals in the post-control period.*

## A note on some tricky numbers

The base-rate wage indicator used here is important, but it has some shortcomings. Among them:

1. The average increases shown are in the base rate, the rate paid to the

Average Increase in Base Rates  
(Bargaining units of 500+; ex. construction)



\*Data are subject to minor adjustments

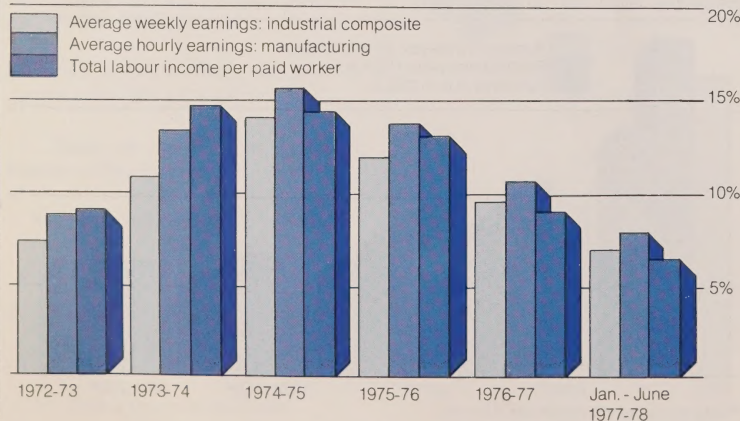
lowest paid classification used for qualified workers in the bargaining unit. Thus the changes are only an estimate of the average increase for all employees covered by the major settlements. Since many contracts introduce cents-per-hour increases rather than percentage increases, the base rate changes will overestimate, to some extent, the average increase in labour income. As an offsetting factor, the base-rate data *do not* include increases in the compensation package associated with other types of benefits such as pension plans, vacation time, or health and welfare benefits. The absence of total compensation changes in this aggregate indicator serves to underestimate the average increase in labour income.

2. Percentage changes for the major settlements do not generally incorporate future COLA amounts, so in these cases the actual increase in labour income is understated. This weakness in base-rate data grows as COLA clauses proliferate, as they have in manufacturing.

### Bigger picture, same view

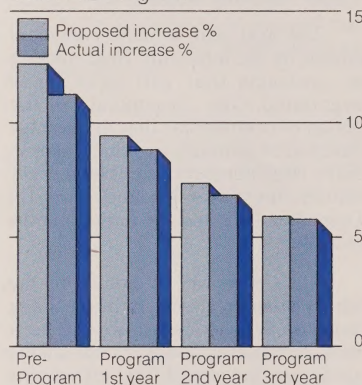
As the larger chart below indicates, a broader horizon—going beyond major contracts (covering 500 or more employees) to the more broadly based labour-income statistics—reveals similar trends. There was rapid acceleration in earnings between 1973 and 1975, followed by a distinct moderation in the rate of increase, then a downward trend that continued to the end of the first quarter of this year.

### Year-to-year Changes



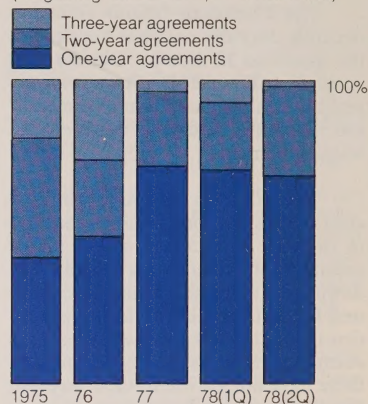
As with the base-rate data, none of these aggregate compensation measures should be given undue importance when viewed in isolation. For example, the average weekly and hourly earnings data can be influenced by developments other than direct wage-rate changes—such as changes in overtime hours and pay, and inter-industry and inter-occupation employment shifts. Taken as a group, and read alongside the base-rate data, the trends in these earnings measures are important indicators of the labour cost situation.

### Compensation Increases under AIB Program



From its own files the AIB has developed aggregate indicators in which compensation is defined as the cost incurred by the employer, including straight-time pay, projected cost-of-living adjustments, benefits, and incentive pay. Charted above, this information reveals a substantial decline over the three control years in both proposed

### Employees Covered by New Settlements (Bargaining units of 500+; ex. construction)



and actual compensation increases. The permitted increases fell from 8.94% in the first full year to 5.75% in the third year of the controls program.

Without doubt the program has been a significant factor in reducing the rate of growth of compensation. But other economic forces were at work, too, and a great deal of sophisticated analysis would be needed to disentangle all the causes and effects.

### The frantic months ahead

The relatively heavy schedule of expiring agreements throughout the summer months will be followed by a lull in October and November. As usual, the end of the calendar year will bring hectic bargaining activity in the unionized sector of the work force. And large numbers of non-union paid workers are being released from controls in the last quarter, particularly the end of December.

The normally heavy year-end schedule has been accentuated by the significant increase in the use of one-year agreements in 1977 and the first quarter of 1978. Fully 71% of the employees involved in major collective bargaining settlements in 1977 were covered by one-year agreements. The consequence will be a particularly active round of bargaining in late 1978 and 1979.

The schedule of expiring contracts for the latter part of 1978 does include several major collective bargaining agreements covering large numbers of employees. One might note, as examples, the large number of Government of Ontario employees in

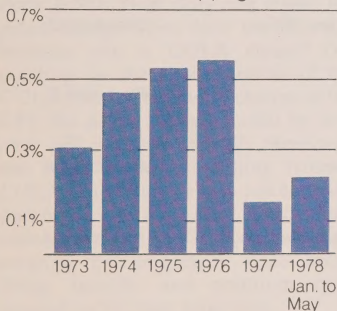
September and December, the Bell Canada workers in November, the 90,000 railway employees in December, and the Saskatchewan teachers in December. While such large groups are important in the establishment of the pattern of wage settlements, one cannot, at this time, highlight individual settlements that should be given particular attention.

## Work stoppages in Canada

During 1977 work stoppages in Canada idled only 0.15% of estimated total work time. The temptation to attribute this situation entirely to the presence of controls is quickly cooled by the realization that the percentage of time lost in 1976—also a year of controls—was the highest since 1946.

The initial five months of 1978 indicate some increase in the frequency of work stoppages but the amount of total work time involved is still well below the 1975 and 1976 levels.

Percentage of Total Working Time Lost due to Work Stoppages



The end of AIB controls will have some impact since the constraints on the collective bargaining process have been eased. This together with the heavy schedule of expiring contracts may result in increased disputes and work stoppages. Serious consideration must be given to the resulting lost production and the cost to third parties. However, the implications of the resulting wage settlements are, in many respects, more critical. If settlements return to the double-digit levels of 1974, 1975 and 1976, the underlying cost pressures will again cut into the competitiveness of the Canadian economy. And that we can ill afford.



"What, I said, if this time we open the Napoleon brandy at the start of negotiations, instead of at the end?"

## COLA clauses: point counterpoint

A cost-of-living allowance (COLA) clause in a labour contract requires the employer to increase his employees' rate of pay automatically in response to increases in some measure of inflation, usually the Consumer Price Index.

In Canadian labour contracts there is no real uniformity in COLA clauses. Some take account of all increases in the CPI. Some only become effective when the rate of CPI increase exceeds a given rate (e.g., 6% a year). The extent to which an employee is covered for inflation by a COLA clause depends on the responsiveness of the wage rate to changes in the CPI.

When a COLA clause is in effect, there is often a cents per hour increase in response to a specified point increase in the Index (e.g., 1 cent for each 0.3 points that the CPI rises). Since many contracts combine a basic increase in the wage rate with a COLA clause, often the COLA clause alone does not provide coverage for all of the increase in the CPI.

A note of caution: many COLA clauses describe wage changes that will occur for *point* increases in the Index. A one *point* CPI increase should not be confused with a 1% increase. The July 1978 CPI was 177.7. A one *point* increase to 178.7 is a 0.56% increase.

The recently signed contract between the Steel Company of Canada and the United Steelworkers of America provides a good example of the use of a COLA clause. The greatest part of the wage increase over the three-year period of the contract will result from a

COLA clause, rather than the yearly base-rate increases.

At the end of the previous contract, 31 July 1978, the base-wage rate for job class 10 (an average job class) was \$7.75 per hour. The basic wage increase effective last August 1 was set at 20 cents per hour, or just over 2.5%.

The Stelco contract provides that:

- The wage rate will increase in response to *any* increases in the CPI.
- The increase will be 1 cent per hour for each 0.3 *point* rise in the CPI.
- The COLA calculation will be made quarterly.

To determine the responsiveness of wages to various percentage increases in the CPI, we estimated the impact on the wage level of two hypothetical CPI increases of 7% and 8% over the first year ended 31 July 1979.

	7%	8%
July '78 CPI	177.7	177.7
July '79 CPI	190.1	191.9
Point Increase	12.4	14.2
Converted to Cents per Hour (1¢ per each 0.3 points)	41.0	47.0
Wage-rate increase	5¼%	5⅝%
Inflation coverage	73%	73%

The first year of the Stelco contract provided the job class 10 employees with a 20 cents per hour (or just over 2.5%) increase, plus a COLA increase equal to 73% of the assumed advance in the CPI. Since the wage rate varies by job class and for subsequent years of the contract, the percentage increase and the inflation coverage factor will also differ somewhat.

# The crowded bargaining calendar

(A sampling of some forthcoming negotiations that could help establish a post-controls trend. The list is not comprehensive).

Employer	Union	Bargaining Unit	Expiry Date
Bell Canada (Quebec and Ontario)	Communications Union of Canada	8,000 traffic operators & dining service employees	November 24
Air Canada	Canadian Air Line Pilots Association	1,700 pilots	November 30
Associated Clothing Manufacturers of the Province of Quebec Inc., Montreal Clothing Contractors Association Inc., Mens' Clothing Manufacturers Association of Ontario	Amalgamated Clothing & Textile Workers Union	10,500 clothing workers	November 30
Bell Canada (Quebec and Ontario)	Canadian Telephone Employees Association	15,220 clerical and associated employees	November 30
Bell Canada (Nfld., Que., Ont., N.W.T.)	Communications Workers of Canada	13,000 craft & service employees	November 30
Garment Manufacturers Association of Western Canada, Winnipeg	Amalgamated Clothing & Textile Workers Union	2,150 clothing workers	December 14
Government of Canada	Public Service Alliance of Canada	4,945 general technical, social science support & technical inspection employees	December 24
B.C. Terminal Elevators Association, Vancouver, B.C.	Grain Workers Union	600 grain elevator employees	December 31
Board of School Trustees of various School Districts, B.C.	B.C. Teachers' Federation	14,470 teachers	December 31
British Columbia Maritime Employers Association (various ports)	International Longshoremen's & Warehousemen's Union	4,000 longshoremen	December 31
Canadian Pacific Express (Atlantic, Eastern & Western Regions)	Brotherhood of Railway, Airline and Steamship Clerks, Freight Handlers, Express and Station Employees	2,935 trucking employees	December 31
Government of Canada	Canadian Air Traffic Controllers Association	2,200 air traffic controllers	December 31
Montreal City	Association des Pompiers de Montreal	2,300 firemen	December 31
Ontario Government	Ontario Public Service Employees Union	27,900 clerical, office, operational and maintenance employees	December 31
Quebec Hydro-Electric Commission	Canadian Union of Public Employees	9,500 technicians & office employees	December 31
Railway Association of Canada, CNR, CPR, and other shortline railways	Associated Railway Unions	90,000 railway employees	December 31
Saskatchewan Government & Saskatchewan School Trustees' Association	Saskatchewan Teachers' Federation	10,820 teachers	December 31
Vancouver City and Regional District	Canadian Union of Public Employees, Vancouver Municipal & Regional Employees' Union	5,265 inside & outside employees	December 31

# Wage changes are not just simple arithmetic

The settlement between the Iron Ore Company of Canada (and its subsidiaries) and various unions is a good example of the problems associated with interpreting contract changes.

The Iron Ore Company contract has been widely reported as being a "30% increase over three years".

Unfortunately, the increase in labour compensation due to new settlements can rarely be described so clearly and accurately. There are two very common sources of ambiguity:

First, it is extremely difficult to report in a simple manner the value or cost of changes in fringe benefits. As a hypothetical example, how does one express the cost to the employer and value to the employees of an additional week of vacation after 22 years of service instead of 24?

Second, the increased use of COLA clauses means that part of the wage increase is not stated explicitly but is dependent on changes in the Consumer Price Index. How does one report the actual change when there is a 3% wage increase *plus* a COLA clause? Depending on the characteristics of the COLA and on the rate of change of the CPI, the actual increase could be well over 10% or barely over 3%. Moreover, the wage increase resulting from a COLA clause may or may not be made part of the base wage rate. This decision influences the total compensation received by employees since many fringe benefits and premium rates depend on the base wage rate.

Why is such a technical issue of any interest to the Centre? Quite simply, the analysis and presentation of wage increases does influence the public perception of the current trends in settlements. Errors in public perception can occur if major, high-profile contracts are oversimplified. In some cases, where there is no single, "correct" way to report a wage increase, the presentation of only one of the possible interpretations can give an unbalanced view of what has taken place.

In the Iron Ore Company contract the base-rate wage will in fact increase by just less than 30% over the next three years. From a different perspective, however, the wage change may be in the order of 22% over the three-year

period, depending on the growth of the CPI.

The key to the Iron Ore Company contract is the wage paid to workers on the basis of a COLA clause that was in effect during the previous contract. During that period, the COLA clause had increased the wage rate by 94 cents; this component of the wage rate had *not* been included in the base wage rate. In the jargon of the trade, the 94 cents was being paid as a COLA "float".

Consequently, the base wage on February 28, 1978, was \$7.30 per hour and there was a COLA float of 94 cents, for a total of \$8.24 at the end of the last contract.

As of March 1, 1978, the commencement of the new contract, the base rate was increased by 34 cents per hour. As of January 1, 1979, a total of 95 cents (the COLA float of 94 cents plus an additional cent) will be built into the base wage.

Should 94 of the 95 cents added on January 1, 1979 be considered an increase in the wage rate? Without doubt it will be a new increase to the base-rate wage. But, since the workers had already been receiving a 94-cent COLA float up to February 28, 1978, is it really an increase in the wage to the workers? Should the movement from a COLA float to the base wage rate be considered an increase in wages?

The point is that the Iron Ore contract does not unambiguously provide a 30% increase in wages.

Two of the many ways to calculate the increase are shown below; for the purposes of the calculation, we have chosen a purely hypothetical example where the CPI increases by 8%, 7%, and

6% for the three years of the contract respectively. In this particular instance, the method that accounts for the COLA float describes a lower increase (22.2%) than the method that includes only the changes to the base rate (29.3%). This outcome is due to the fact that the COLA float at the start of the three-year contract is larger than the estimated COLA float at the end of the contract.

Even this presentation is overly simplified, since it does not take into account the impact of fringe benefits on premium wages (e.g., overtime rates) that results from paying benefits via the base wage rate rather than in the form of a COLA float. As well, we have not attempted to explain the changes in supplementary pension plans that will yield some benefits to the employees.

There is no "correct" and simple answer. We are of the view, however, that the change over three years including the value of the COLA payments (while not entirely correct) is a more accurate description of the change that occurred with the introduction of the new Iron Ore Contract than is the use of base-rate data alone. The Iron Ore contract could be described, then, as providing an increase in the order of 22% over 3 years, on the basis of the hypothetical increase in the CPI.

The increased frequency of COLA clauses, the considerable importance of fringe benefits, and the difference between base rates and average rates, will seriously complicate the easy understanding of individual labour contracts and the "trend" in wages in Canada. Where possible, we will report on particularly complex settlements.

## Method #1: Calculating Base Wage Rate Changes

Base Wage Rate February 28, 1978	\$7.30
Estimated Base Wage Rate February 28, 1981	\$9.44
% increase	29.3%

## Method #2: Calculating Effective Wage Changes, Including COLA Payments

Base Wage Rate Plus COLA Float February 28, 1978	\$8.24
Estimated Base Wage Rate Plus COLA Float February 28, 1981	\$10.07
% increase	22.2%

# A new measure to monitor inflation

Inflation affects the activities of all Canadians in consumer, labour, government, business and financial fields. If we are all to see ourselves engaged in common cause to contain inflationary pressures in our economy, it is important to agree on a way to measure our collective success or failure.

Most of us judge the rate of inflation on the basis of our personal experience with prices of goods and services we purchase regularly. Hence the importance we have come to attach to movements in the Consumer Price Index published monthly by Statistics Canada.

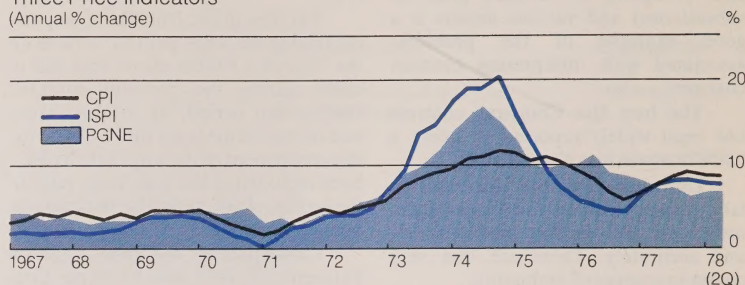
Yet in many ways the CPI is less than a fully satisfactory measure of inflation. For one thing it assumes that consumers buy the same quantity of the same goods each month regardless of any changes in supplies, prices and incomes. It, therefore, fails to allow for the effects of relative price changes on purchasing decisions. When prices are rising rapidly, consumers usually switch from more expensive goods to cheaper ones, but the CPI does not reflect this switch; it shows a higher price impact on consumers than has actually occurred. In addition it is difficult to adjust the CPI for changes in the quality of goods and services.

Despite these deficiencies the CPI is still the best readily available measure of the impact of inflation on consumers. It has timeliness, broad coverage, and a long continuous history.

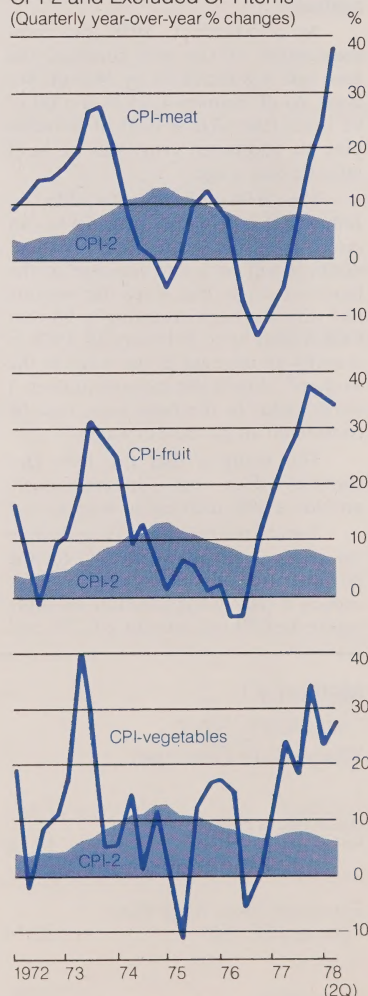
But for measuring the changes in the rate of inflation over a relatively short period of time, it is often inappropriate since it includes some products whose prices vary widely and erratically for reasons *not* related to ongoing inflationary pressures in the economy. Wage and price decisions based on such short-run erratic fluctuations in the CPI can be very damaging to the economy, particularly to the competitive position of Canadian industry at home and abroad.

Other price series exist which also measure a wide range of prices (see chart). The Industry Selling Price Index (ISPI) measures selling prices in over 100 manufacturing industries. It is more reliable at the individual industry level than at the aggregate level, where there is a good deal of double-counting as finished products show up as raw and partly manufactured products at

Three Price Indicators  
(Annual % change)



CPI-2 and Excluded CPI Items  
(Quarterly year-over-year % changes)



various stages of the manufacturing process. Since it is a measure of the selling prices of Canadian firms, by definition it includes export prices but it excludes the impact of price changes for imported goods. Nevertheless the ISPI is a useful indicator of specific price movements for individual commodities and industries and of future broad movements in overall inflation levels in the economy.

Yet another price measure is the implicit price index for Gross National Expenditure (PGNE). This quarterly index is an indicator of prices for the *total* current output of goods and services. Because it subtracts the influence of import prices from domestic prices and adds the effects of export prices, it is often not a good reflection of prices paid by Canadians. In addition it is a volatile series subject to frequent revision.

In order to present a smoother monthly price measure—one less subject to relatively short-run, volatile price movements but still broadly representative of the consumer rate of inflation—we have devised a special measure of basic inflationary pressure in the economy. This index includes roughly 93% of the individual items contained in the CPI and uses the same weights and methodology. Only three items which together constitute less than 7% of the total CPI have not been included in the new index—meat, fresh fruit, and fresh vegetables.

As shown in the accompanying chart, prices of these three goods exhibit extreme volatility in the short-run because of variable weather conditions affecting fresh produce and wide variations in the meat-supply cycle. While

the short-run changes in these prices represent a change in the purchasing power of Canadian consumers, they distort the extent of inflationary pressures in the Canadian economy.

Over long periods of time, the movements of this new index (let's call it CPI-2), the three excluded items, and the CPI have been very similar. For example, over the 16-year period from 1962 to 1977 CPI-2 rose at an average annual rate of 5.2% compared with an average increase of 5.0% for meat, fresh fruit and vegetables, and 5.1% for the total CPI. The CPI-2 is as representative of the long run rate of inflation as is the CPI, while being a better short run measure of basic inflationary pressures and the success of government policy.

The exclusion of the volatile prices does *not* mean that these items are unimportant and are being ignored by the Centre. On the contrary, their exclusion from the general index means that we are paying special attention to their price developments.

In addition to watching CPI-2 itself, we will be looking at the movement of its components. The chart opposite illustrates the movements since 1972 in CPI-2 and in the indexes of food prices, energy prices, government-determined prices, and other prices. (Government-determined prices have been defined to include such items as mortgage interest, property taxes, postage, tobacco and alcohol, and local transit charges.)

During the period 1961 to 1970, most prices moved relatively slowly. CPI-2 increased at an average annual rate of 3.7%, energy prices rose only 1.5% a year (and actually declined some years), and food prices (excluding meat and fresh fruit and vegetables), government-determined prices and other prices rose at annual rates of 2.8%, 4.3%, and 2.8% respectively.

From 1971 to the present price changes have been much more volatile and large. CPI-2 recorded changes ranging from a low of 3.2% in 1971 to 11.5% in 1975, then down to 7.9% in 1977 and 6.4% on a year-over-year basis in July of this year. During this time swings in CPI-2 have diverged from the total CPI. For example, in the year ending November 1976, the total CPI increased 5.6% while CPI-2 showed a more gradual deceleration, increasing at

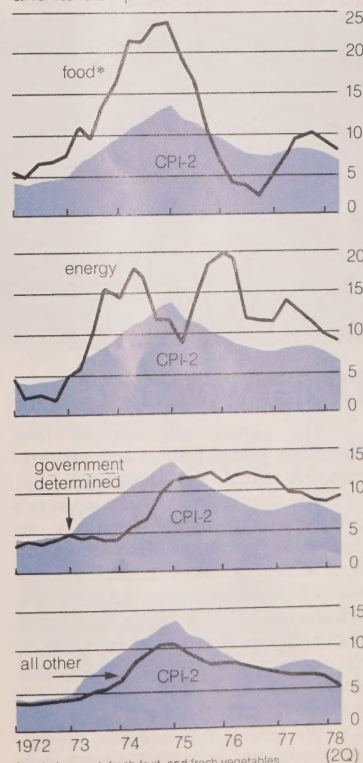
7.1% as prices of meat, fresh fruits and fresh vegetables declined 9.5%.

The importance of watching an index like CPI-2 cannot be over-emphasized. In 1976 when the CPI increase was unexpectedly low because of declining food prices, CPI-2 would have provided a much less optimistic view of Canada's inflation performance.

As expected the CPI increased more rapidly than CPI-2 from the second half of 1977, as meat prices began their rapid cyclical upswing, and weather conditions, principally in the southern United States, resulted in very large increases in the prices of fresh produce.

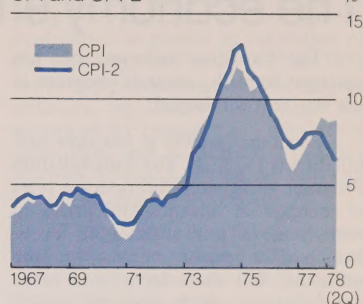
The CPI-2 paints an interesting picture of inflation over the past few years. During 1974, the index underwent its largest monthly gains, and by the first quarter of 1975 stood a full 13.3% above its earlier level. Some moderation occurred during 1975 but CPI-2 continued to post sizeable

Year-to-Year Changes in CPI-2 and its Components



\*excludes meat, fresh fruit, and fresh vegetables

CPI and CPI-2



quarterly increases averaging roughly 10% at annual rates.

In 1976, the rates of increase of CPI-2 began to moderate as the increase in world prices levelled off, the Canadian dollar appreciated, and the increase in food prices (excluding meat, fresh fruit and fresh vegetables) slowed considerably. Quarterly price increases averaged about 8% at annual rates.

The depreciation of the Canadian dollar led to a rapid rise in import prices in 1977, offsetting declines in the rate of increase of many domestic prices. This left the inflation rate as shown by CPI-2 fairly steady at around 7% to 8% through 1977. Only the remaining food component of CPI-2 actually increased more rapidly in 1977 than earlier.

Recently there has been a sharp contrast in the moderation shown by CPI-2 and the explosive performance of the total CPI, due almost entirely to the three excluded items: meat, fresh fruit and fresh vegetables.

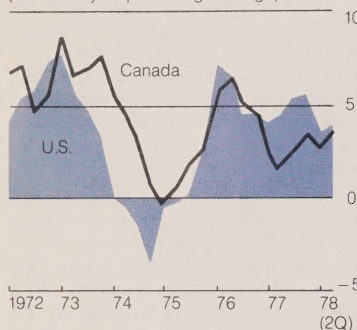
By August of this year these three items had risen 40.5% above their year-earlier values. Other food prices increased 7.8% in the same period. The rate of increase in energy prices was 9.9% over the year while the rate of increase recorded by government-determined prices was 8.4%; other market-related items rose by only 5.3% due in part to the cuts in sales taxes. While the total CPI rose 9.4% in the twelve months ending August, CPI-2 increased 6.7% illustrating just how much the movement of prices of the excluded items can deviate from the movement of prices in general. Thus, we believe CPI-2 is a better indicator of basic inflationary pressures in the economy and that Canada recently has made more improvement in its price performance than the CPI alone indicates.

# The economy emerging from controls

The Canadian economy has not emerged from the controls program in the way that was hoped.

Economic growth is too slow and inflation is too high. The Anti-Inflation Program, designed to bring down rates of increase in incomes and prices to more realistic and sustainable levels, has had a major impact on the economy. But there have been other developments which were not anticipated.

Real GNP  
(Year-over-year percentage change) %



Growth in the international economy has been lower than expected. International inflation, on the other hand, has been higher—a world-wide phenomenon, particularly evident in food prices, especially in North America.

The depreciation of the Canadian dollar began in November 1976 and has continued unevenly. While it has helped the growth of Canadian output by improving Canada's international competitiveness, it has also hindered Canada's attempt to reduce its rate of inflation, although the battle to contain inflation has had more success than the CPI alone indicates (as explained in the two preceding pages).

On the domestic front the growing gap between incomes and prices and the reduced rate of growth in government spending meant that the total demand for goods and services was weak. With output growth sluggish industrial capacity went unutilized and the productivity gains allowed for in the Anti-Inflation Program were not realized. Thus labour costs per unit of output and Canada's competitive

position did not improve as much as was hoped. This has put further downward pressure on the dollar.

Canada's recent economic performance underscores the way in which inflation, consumer demand, output, productivity and international competitiveness are closely linked. Failure to achieve satisfactory performance in any one of these areas has consequences for all the other links in the chain.

## The foreign sector

The major contribution to growth in the Canadian economy over the last two years has been Canada's foreign trade, greatly assisted by the decline in the value of the Canadian dollar. But the improvement has been uneven and we still have a substantial deficit in our total international transactions in goods and services.

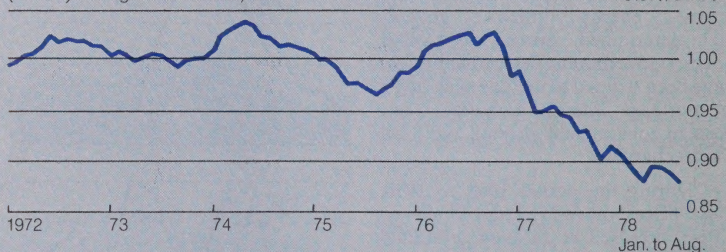
Through the 1970s up until 1976 costs and prices for Canadian output in both domestic and foreign markets moved out of line with our major

competitors, and Canadians and foreigners increasingly gave preference to foreign-made products over competing Canadian-made products. As a result Canadian output rose less than it would have otherwise.

Such a loss in competitiveness would normally have caused a significant decline in the value of the Canadian dollar. But other developments prevented this from happening. World prices for many primary products which Canada exports, such as wheat and minerals, were rising and Canadians were borrowing heavily outside Canada, particularly in 1976. Both of these events put upward pressure on the exchange rate and the Canadian dollar actually appreciated in value against the U.S. dollar.

At some point, however, particularly in a small open economy such as Canada's, an adjustment process must occur. That point was reached internally when our rate of inflation started to moderate in the latter part of 1975, and our prices and cost increases began

Canada-United States Exchange Rate  
(Monthly average of noon rates)



## Dollar watching

The Centre will examine how Canadian prices, output and employment are affected by depreciation.

The depreciation of the country's currency immediately improves its competitive position. Exporters find that to the extent their products are based on domestic costs, they can now sell abroad at a lower price. Moreover, because the price of imports rises due to the depreciation, producers of domestic goods are in a better competitive position to sell within Canada.

We believe that domestic producers should not increase their prices to

match the increased price of imports but instead should use their enhanced competitive position to increase their penetration of Canadian markets.

The external value of the Canadian dollar has depreciated substantially. This should result in a great improvement in our international competitive position.

In the coming months we will be watching the results of the depreciation on an industry-by-industry basis to see whether the Canadian economy receives the maximum possible benefits.

to move into line with those of our major trading partners. This improvement was extremely beneficial, but it was not large enough or fast enough to prevent the dollar from depreciating.

The decline of the dollar represents a needed adjustment from a position that was clearly unsustainable. But currency depreciation adds to inflationary pressure because the prices of imports rise and prices of many Canadian-made goods which compete with imports go up too.

The dollar depreciation has given a strong boost to our international trade, making foreign trade the major contributor to Canada's economic growth over the past two years.

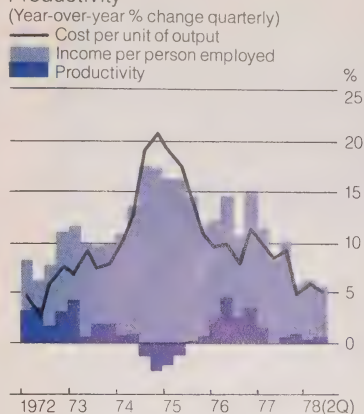
Nonetheless we cannot look to foreign trade to fuel the growth of the economy over the next year or two as we have in the recent past. Although the amount of the depreciation of the dollar to date has significantly improved our competitiveness on international markets, the rate of growth of the United States economy has slowed down and demand from outside North America has not increased as quickly as expected. In addition, the largest part of the impact of the depreciation has already been felt, and it is unlikely that the dollar will decline much further.

## The domestic scene

Although governments and business both contribute to the demand for goods and services within Canada, demand from individual consumers accounts for 60% of the total domestic demand in the economy.

The strength of consumer demand is mainly determined by how individual incomes are growing, and how much they are affected by inflation and taxes. As a result of the controls program, and high unemployment levels, wages and salaries in Canada have not increased as much over the past two years as they did in the preceding few years. From the first half of 1976 to the first half of 1978 wages and salaries per employee rose by an average 8% per year, about one-half the rate of increase in 1975. After allowing for inflation, the increase in this two year period was only 1/2% per year. Real wages and salaries of employees usually increase in line with growth in productivity, which over the past 25 years in Canada has been at the rate of about 2% per year. But in the 7

years from 1969 to 1976, the growth in real incomes averaged 3 1/2% per year. By the second quarter of 1978 wages and Labour Income, Costs and Productivity

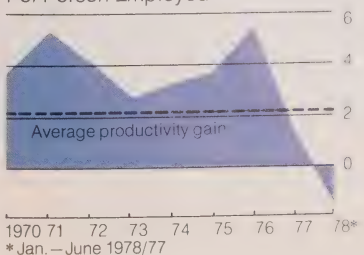


salaries of employed persons (after allowing for inflation) were 20% higher than in 1971. This compares quite favorably with a 7 1/2% increase in the United States over the same period.

In 1977 wage increases in Canada began to moderate significantly, and at the same time the rate of inflation increased so that real wages were squeezed. By 1978 wages and salaries per employee, after allowing for inflation, were actually declining.

The amount of income that was available to consumers, after allowing for inflation and taxes, rose by about 3 1/4% per year over the two-year period. At the same time consumers reduced their rate of savings slightly so that the demand for goods and services was given an extra nudge. Even so the rate of growth in consumer demand was little more than half the rate of the previous two years.

## Real Labour Income Per Person Employed

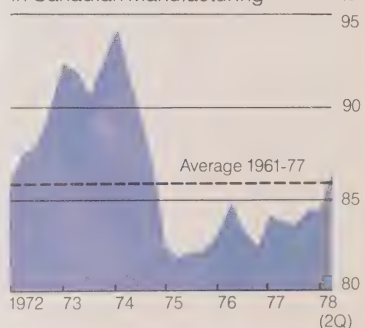


In the past, government spending on goods and services has usually contributed to growth in the output of the economy, and from 1973 to 1975 government spending, after allowing for inflation, significantly outpaced the growth of the economy as a whole. But since 1976 real government spending has risen by less than 1 1/2% per year and has been a drag on the economy.

With output growth so sluggish and industrial capacity already lying idle, there has been insufficient incentive for business to invest in new plant and equipment, although the energy industries have provided some strength.

In total, then, the output of the Canadian economy has increased by less than 3% per year over the past two years, compared with a potential growth rate of between 4% and 5%. Because actual growth has been below potential, unemployment has risen and unused manufacturing capacity has increased. The chart shows that in the two years since 1976, Canadian manufacturers have been operating at about 84% of capacity, compared with an average 86% for the period from 1961 to 1977. In the second quarter of this year the

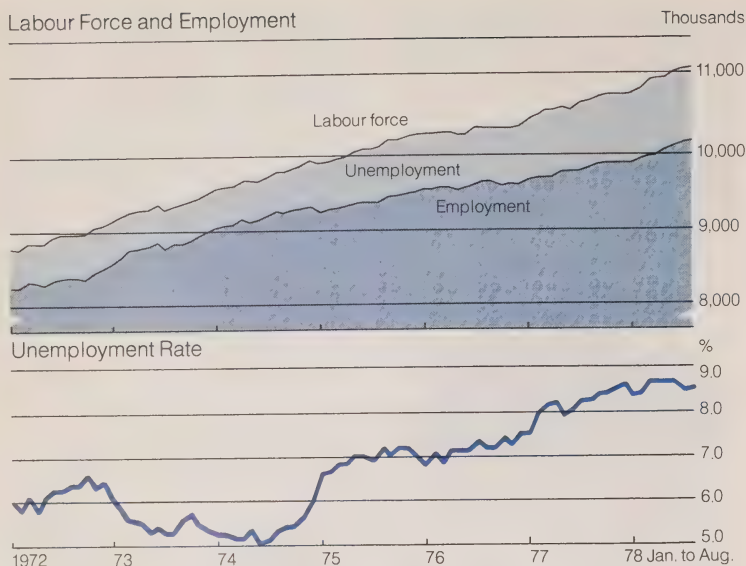
## Capacity Utilization in Canadian Manufacturing



rate of capacity utilization rose to 86.4%.

When the economy is growing slowly, it is usually difficult to increase output per person employed, which is the way productivity is normally defined. But Canada's recent productivity performance has been unusually bad. In the two years ending the second quarter of this year, the value of output per person employed, after allowing for inflation, increased by only 1/2% per year. This may have been the result of

## Labour Force and Employment



poor productivity performance in the service industries, as part-time employment increased in relation to full-time employment. In the goods-producing industries, output growth was slow, but the number of people employed rose even less, so output per person employed (productivity) increased. Manufacturing industries did particularly well, and their productivity increased at twice the rate of the goods-producing sector as a whole.

The relatively strong growth in the service industries coupled with the squeeze in real incomes, combined to attract larger numbers of Canadians into the labour force. Although employment increased by 2¼% per year from the first half of 1976 to the first half of 1978, the 432,000 new jobs created were not enough to provide employment for all those seeking work, and so the number of unemployed increased by 211,000.

## Sales tax reductions expire

In April of this year, as part of an effort to stimulate the economy at a cost for governments of over \$1 billion, nine provincial governments, with federal assistance, reduced their sales taxes. (There is no sales tax to cut in Alberta). In addition to influencing demand by encouraging consumers to buy more, cutting sales taxes reduced the Consumer Price Index since sales taxes are part of the final price of the goods we purchase.

Statistics Canada has estimated that since the provincial sales tax cut in April, the CPI has been about 0.7% below the level that would otherwise have been observed. The low increase in the CPI between March and April of 1978 (a month-to-month increase of only 0.2%) reflects the influence of the sales tax cut.

This month (October) the first phase of these sales tax restorations is scheduled to occur. Six provinces (Newfoundland, P.E.I., Nova Scotia, New Brunswick, Ontario and Manitoba) will increase their tax rates by three percentage points. We estimate that this phase of sales tax increases will add 0.4% to the national level of prices, as measured by the CPI, in the month of October. In the provinces directly affected, the impact on the level of

prices will be somewhat greater—ranging from around 0.6% in Prince Edward Island to about 0.9% in Manitoba. Much of the difference in provincial impact is attributable to the different coverage of the sales tax in each province.

Saskatchewan is scheduled to raise its sales tax by 2% in January 1979, while Quebec is expected to restore the

0.3% with most of the increase being felt in April 1979. British Columbia has permanently reduced the sales tax rate by 2%.

The phased increasing of provincial sales taxes will eventually increase the CPI by about 0.7%. Because of the permanent nature of the sales tax cut in British Columbia and the introduction in Newfoundland of a higher sales tax



full sales tax on the selected items involved in April 1979. The combined impact of the increases in these two provinces on the national price level will probably be somewhat less than

rate, the overall reduction and re-introduction of the provincial sales taxes have about the same average impact: 0.7% lower in April 1978 and 0.7% higher by the time the last cuts expire.

## How to profit by getting smart

it cook, superb seamstress, and accountant, and rewinds films in her spare time. Their three sons are all former CFL players who have returned to the city with a few medical problems<sup>7</sup> there, however, more than offset by degrees in agronomy, botany, business administration, and even economics.<sup>8</sup> And that's what called "labour productivity".<sup>9</sup>

The trouble is, if Fred, Doris, and the boys work just as hard<sup>10</sup> but get ease in total production as a result of investing in new milking equipment, or a new and better feed, or sheds and silos, or a better bull, all that an increase in "labour productivity"?<sup>11 12</sup> netimes.<sup>13</sup>

We can also calculate the rate of return on Fred's capital investments. We possibly call that "capital productivity"? Why not?

Now we can really get fancy. Let's call all of Fred's purchased inputs—such as seed, fertilizer, feed, and whatever, make an adjustment for inventory<sup>15</sup>, and come up with a figure on *net* value of production—high economists call "value added".<sup>16</sup>

Then let's divide this value added by all sorts of things—man-hours, spent on machinery and equipment, acres of land, area of feeding, hours of sunshine, and so on.<sup>17</sup> Congratulations. You have just created your own measure of Fred's productivity. You are now ready to be the subject of national productivity.<sup>18</sup> National productivity is what we have enough of before we all ourselves big pay raises in the

early 70's. This was very silly and we were just asking for it.<sup>19</sup>

Back to the farm:<sup>20</sup>

If Fred, Doris and the boys took a total of \$10,000 into their own purses in 1976, and then took \$15,000 in 1977 even though the value of their production—or their value added, if you prefer—did not go up, what have we got here (besides a suspicion that Doris fiddled the tax return)?

Trouble. In effect they've borrowed from next year's production. They can't go on doing that.

Same with the whole country:

If Canadians as a whole take money out of the system at a rate faster than their productivity increases, they invite trouble.<sup>21</sup>

Or to put it another way:

There is no lasting, trouble-free way yet known to man for a country's people to increase their incomes faster than the rate of increase in the total value of goods and services produced per person employed. If people borrow against future production, they always have to pay it back somehow. When the added production doesn't materialize, something has to give.<sup>22</sup>

So prosperity hangs on productivity. Now if only we could call it something else.

How about smart?

*The government announced today that Canadian smart increased by 10 per cent last year. The gain was attributed to better management, a more productive combination of labour and equipment, and more attention to doing things that we do best. A continued improvement in smart is bound to lead to higher incomes and less inflation, the government said.*

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Study of Inflation  
and Productivity  
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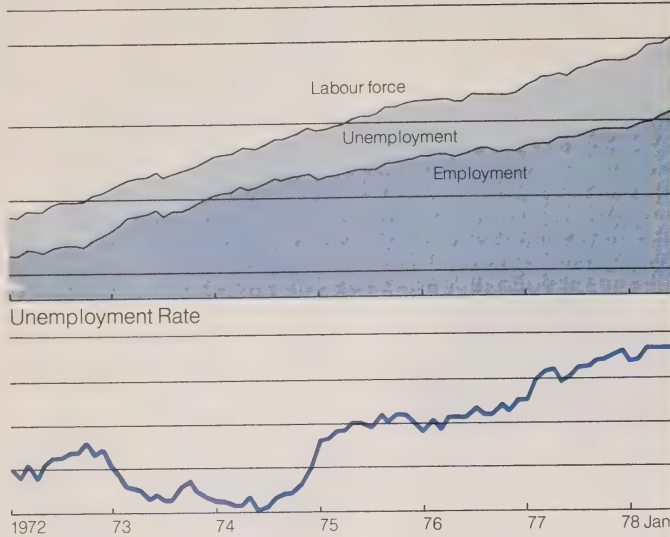
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## ERRATUM

THE LAST PARAGRAPH ON PAGE 23 SHOULD BE  
CORRECTED TO INCORPORATE THE WORDS  
UNDERLINED.

## Labour Force and Employment



## Sales tax reductions expected

In April of this year, as part of an effort to stimulate the economy at a cost for governments of over \$1 billion, nine provincial governments, with federal assistance, reduced their sales taxes. (There is no sales tax to cut in Alberta). In addition to influencing demand by encouraging consumers to buy more, cutting sales taxes reduced the Consumer Price Index since sales taxes are part of the final price of the goods we purchase.

Statistics Canada has estimated that since the provincial sales tax cut in April, the CPI has been about 0.7% below the level that would otherwise have been observed. The low increase in the CPI between March and April of 1978 (a month-to-month increase of only 0.2%) reflects the influence of the sales tax cut.

This month (October) the first phase of these sales tax restorations is scheduled to occur. Six provinces (Newfoundland, P.E.I., Nova Scotia, New Brunswick, Ontario and Manitoba) will increase their tax rates by three percentage points. We estimate that this phase of sales tax increases will add 0.4% to the national level of prices, as measured by the CPI, in the month of October. In the provinces directly affected, the impact on the level of

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Saskatchewan is scheduled to increase its sales tax by 2% in January, while Quebec is expected to rest



full sales tax on the selected items involved in April 1979. The combined impact of the increases in the sales taxes in the provinces on the national price level will probably be somewhat less



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We expect food prices on average to show little or no increase for the rest of 1978. But because of price increases which have already taken place, the food consumed at home component of the consumer price index will end the year at least 12% above December 1977. We expect food price increases to moderate considerably next year.

## r how to profit by getting smart

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# Productivity footnoted: or how to profit by getting smart

The trouble with productivity in this country is that it has too many syllables.

Intended as a simple economic fact, it has through successive governments and government agencies taken on all the characteristics of a priestly incantation—you don't have to fully understand productivity as long as you agree it's important.<sup>1</sup>

If you say "Fred Smith runs a very productive dairy farm", everyone<sup>2</sup> will get the idea—namely that Fred has the right amounts and kinds of land, buildings, cows, machinery, equipment, help, health, energy, knowledge and experience plus the knack of pulling it all together; and that given a decent break from God and the government (especially the latter) he might—just might—manage a few back-to-back years of profit and thus get a real choice of whether to spend it or invest it.<sup>3</sup>

All of which conveys pretty well the notion of "productiveness". Old-fashioned word. Simple idea.

Who needs the word productivity anyway?<sup>4</sup>

Statisticians, among others. Productivity is something that can be measured, they say.<sup>5</sup>

Back to Fred's farm:

The productivity of Fred's farm can be described as the dollar value of the farm's production divided by the amount of labour that goes into it in terms of (a) total "employees", of (b) production workers,<sup>6</sup> (c) man-hours,<sup>6</sup> or (d) somesuch.

(As it happens Fred is a dynamo, master mechanic, meteorologist, carpenter, a national authority on dairy farming, and can handle a PTO and Discounted Cash Flow with equally great results. His wife Doris is beautiful,

a great cook, superb seamstress, chartered accountant, and rewinds generators in her spare time. Their three grown sons are all former CFL linebackers who have returned to the farm with a few medical problems<sup>7</sup> which are, however, more than offset by a string of degrees in agronomy, botany, biology, business administration, marketing. Even economics.<sup>8</sup>

And that's what called "labour productivity".<sup>9</sup>

Trouble is, if Fred, Doris, and the three boys work just as hard<sup>10</sup> but get an increase in total production as a result of investing in new milking equipment, or a new and better feed, or bigger sheds and silos, or a better bull, do we call that an increase in "labour productivity"?<sup>11 12</sup>

Sometimes.<sup>13</sup>

We can also calculate the rate of return on Fred's capital investments. Could we possibly call that "capital productivity"? Why not?

Now we can really get fancy. Let's deduct all of Fred's purchased "inputs"<sup>14</sup> such as seed, fertilizer, feed, electricity, and whatever, make an adjustment for inventory<sup>15</sup>, and come up with a figure on *net* value of production, which economists call "value added".<sup>16</sup>

Then let's divide this value added by, well, all sorts of things—man-hours, dollars spent on machinery and equipment, acres of land, area of feeding barns, hours of sunshine, and so on.<sup>17</sup>

Congratulations. You have just calculated your own measure of Fred's farm's productivity. You are now ready for the subject of national productivity.<sup>18</sup>

National productivity is what we didn't have enough of before we all gave ourselves big pay raises in the

early 70's. This was very silly and we were just asking for it.<sup>19</sup>

Back to the farm:<sup>20</sup>

If Fred, Doris and the boys took a total of \$10,000 into their own purses in 1976, and then took \$15,000 in 1977 even though the value of their production—or their value added, if you prefer—did not go up, what have we got here (besides a suspicion that Doris fiddled the tax return)?

Trouble. In effect they've borrowed from next year's production. They can't go on doing that.

Same with the whole country:

If Canadians as a whole take money out of the system at a rate faster than their productivity increases, they invite trouble.<sup>21</sup>

Or to put it another way:

There is no lasting, trouble-free way yet known to man for a country's people to increase their incomes faster than the rate of increase in the total value of goods and services produced per person employed. If people borrow against future production, they always have to pay it back somehow. When the added production doesn't materialize, something has to give.<sup>22</sup>

So prosperity hangs on productivity. Now if only we could call it something else.

How about smart?

*The government announced today that Canadian smart increased by 10 per cent last year. The gain was attributed to better management, a more productive combination of labour and equipment, and more attention to doing things that we do best. A continued improvement in smart is bound to lead to higher incomes and less inflation, the government said.*

It reads well.

And it has only one syllable.

1 Once we had a National Productivity Council; among other good works it preached the need for "rationalization" but that even had more syllables than productivity. The NPC was put away in 1964.

2 Well, almost everyone. Especially here in Fark Township.

3 Fred says that's the thinking man's definition of the "quality of life". He already has enough fresh air.

4 We'd prefer to think the word was invented by a politician or a bureaucrat. Actually its first heavy use was by Lenin.

5 They mean well. As the patient reader will see, they can't *really* measure productiveness. So as long as you can't measure it you might as well call it productivity.

6 In which Fred's wife is excluded. We're just giving the facts.

7 They have excess adrenalin and would rather work than sleep. The doctors are looking into it.

8 There had to be *one* fun subject.

9 Some folks criticize Fred for not hiring extra help.

10 They can choose their own hours as long as they add to 80 each week.

11 Yes

12 No

13 No one has come up with a better term.

14 If you insist on reading economics you're just going to have to accept words like input.

15 An adjustment is something you do when the numbers don't add up.

16 How would it sound if economists went around the country talking about net production?

17 By one at a time, please.

18 Some students spend three years in university and don't get this far.

19 They called it the AIB.

20 And not a moment too soon. This is an apolitical outfit.

21 Trouble invariably accepts. It's here now. It's called inflation and slow economic growth.

22 In our case the exchange value of the Canadian dollar, among other things. When people buy Canadian dollars they want clear title—not a dollar against which we've made a future claim, because we wanted more income now and couldn't wait to earn it.

# More oil price increases to come?

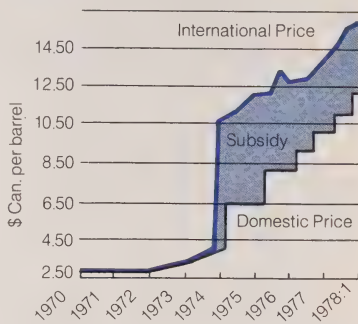
Autumn 1978 is the fifth anniversary of the arbitrary quadrupling of the world price of oil. This huge price increase has caused a massive shift of world incomes to the oil-producing countries, and has created inflationary pressures on a world-wide scale. At the same time the world economic slowdown partly caused by the oil price hike hurt Canadian exports.

Canadians have been partly protected from these developments because they are also producers of oil. In 1974 the oil we imported into Eastern Canada was matched by oil exports from Western Canada to the United States. Since then our oil exports have been reduced to conserve domestic supplies for future domestic use. However, our consumption has grown faster than our production. Result: a growing oil trade deficit, amounting to

18% of our total oil consumption.

Since 1973 the federal and provincial governments have kept the domestic price of crude oil significantly below

Domestic and International Crude Oil Prices



the world level. The objective has been to spread the costs of adjustment more evenly over time and across the country. Imports to Eastern Canada are subsidized to bring the price down to the domestic level—the amount of subsidy depending on the difference between the world and domestic prices. The subsidy has been financed from an export tax on the oil we sell to the United States and a federal tax on gasoline of 7 cents a gallon (recently reduced from 10 cents).

The stated federal government policy is to move the domestic price to the lesser of the U.S. or world price “at a measured pace”. The price gap with the U.S. price in Canadian dollar terms is small, but the gap with the world price is not appreciably smaller than it was four years ago—about \$3.50 per barrel. The August 25 proposal by the Federal Minister of Finance to suspend the scheduled January 1 increase in domestic oil prices would likely lead to a larger price gap.

## U.S. inflation picture darkens

Canada's fight against inflation is not being made any easier by the present situation in the United States.

By December it is expected that the U.S. Consumer Price Index will be 8% higher than a year earlier, after two years in which the increase had been held to about 6%.

As in Canada, food prices are a major factor driving up the overall index; they rose almost 18% in the first half of this year. But other factors are at work that are having important repercussions on U.S. wage and price performance.

Last January payroll taxes were increased. These are the source-deducted taxes that help finance the U.S. social security system; employers pay part.

Also in January the minimum wage was increased by 35 cents an hour to \$2.65. This provided added impetus for non-union workers' wage gains to “catch up” to earlier union increases (an alternating process that may continue).

The effects were felt quickly. Increases in average compensation per hour jumped to an annual rate of 10 per cent in the first half of 1978 (compared with about 8% for the twelve months

ending last December). It now is estimated that these two measures will add 1% to labour costs in 1978, and normally about two-thirds of such increases will be passed on.

At the same time productivity has declined in the first half of this year in the United States (as measured by output per man-hour), resulting in an increase of about 11% in labour costs per unit of production. This will stimulate further price increases.

Economic growth is expected to be slower in the United States this year than in 1976 and 1977. Some economists expect that demand will weaken further in the first half of next year.

Both minimum wages and payroll taxes are slated to increase again in 1979. While the minimum-wage boost will not be as big as this year's, the jump in payroll taxes will be larger.

None of this augurs well for a slowdown in rising U.S. labour costs and prices over the next year. The prospect is for a continuation of the recent higher rates of inflation and there is a distinct possibility that the rates will be even higher. For Canada this makes a tough job even tougher.

## Canadians insulated

Thus partly sheltered, Canadian consumers have nevertheless felt a sharp inflationary impact from the world oil price increases and have faced an unavoidable loss of real income to the OPEC countries. Equally important there has been a drag on Canadian economic activity because real income has been transferred from oil consumers to the oil companies, some provincial governments (mainly Alberta), and the federal government. To the extent that this money is not being spent as quickly or in the same way as it would have been if left in consumers' hands, there has been a reduction in overall demand for goods and services at the very time when the economy has needed more demand.

A change in the price of crude oil affects final prices in many ways. The most obvious effect is the increase in cost of direct energy items such as home heating oil, gasoline and motor oil. These prices increase about 60 days after the change in crude prices—a lag imposed by the federal government so the refiners will process the “old” cheaper oil in their inventories and not get windfall profits. The price of natural

gas, a close substitute for oil in heating and manufacturing, has been linked with the oil price in a way that reflects their relative "heat value". Therefore gas prices also increase about 60 days after a rise in crude oil prices. (It has been proposed to break this link.)

The rise in prices of direct energy causes an increase in the prices of all goods and services whose production has required the use of such energy. Among the most intensive users of petroleum are agriculture, transportation, electricity generation and, of course, petrochemical products. The result is inflation: in response to the increases in prices, income demands rise as consumers attempt to protect themselves against a decline in the real purchasing power of their incomes. The higher incomes "feed back" into higher prices for all items. Thus we get more inflation. The notorious spiral takes shape.

### Income feedback

The precise *magnitude* of the total impact of oil price increases is open to debate. Estimates of direct and indirect price effects, excluding the "income-feedback" effect, range from 0.5% to 0.85% on the Consumer Price Index (over a two year period) for each \$1 per barrel increase in crude oil. The amount of influence of the income-feedback effect is much more difficult to isolate. A very rough estimate of the combined effect would be 1.0% on the Consumer Price Index for each \$1 per barrel increase (.65% on prices, .35% through wages). Since the price of oil in Canada has increased about \$10 per barrel in

the last five and one half years, this would indicate a total Consumer Price Index effect of 10%, or 2% a year on average.

It is important to distinguish between the effect of the oil price

Canadian dollar declines relative to the U.S. dollar, the price of imported oil in Canada increases. In the past year and a half the world price has been stable in U.S. dollars but the depreciation of the Canadian dollar against the U.S. dollar



increase in raising the general price level and the impact of the increase in oil prices relative to other goods and services. While the increase in the general price level has been painful and difficult to cope with, the upward shift in the relative price of oil is a necessary adjustment to discourage oil consumption and to make future Canadian oil production more attractive.

The world price of crude oil is denominated in U.S. dollars. When the

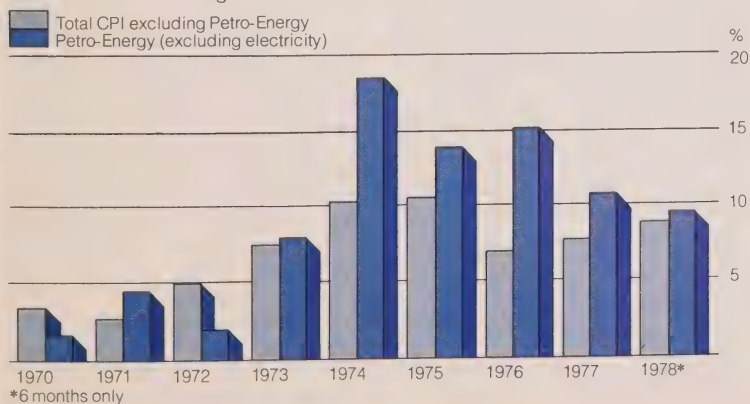
has caused a steady increase in the cost of imported petroleum.

There are two other ways in addition to further depreciation (against the U.S. dollar) that the world price to Canada might increase.

First, the OPEC countries may again raise the international price. Equally as troublesome, OPEC could move away from the American dollar as the "peg" for the price; this would cause the price in Canada and the U.S. to rise if their currencies are depreciated against the currencies of other countries.

Canada is then left in a very vulnerable position over the next few years. We have already absorbed very large doses of inflation as a result of the increases in the domestic oil prices to date. Yet, because the Canadian dollar has been depreciating, the dollar difference with the world price has not become much smaller. On top of this we may face further increases in the U.S. or world prices. The prospects then are not encouraging for those who hope that we could look forward to more stable energy prices. We have come a long way. But the road ahead still looks long and painful.

Year to Year CPI Changes



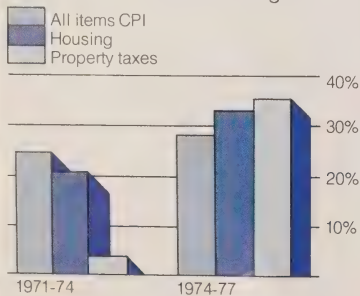
# Property taxes and the CPI

For the early 1970s, local government property tax growth contributed very little to the increase in the Consumer Price Index. The growth for this form of taxation was below other forms of taxation growth due in part to increased provincial transfers to local governments and in part to relatively slow growth in municipal spending. In the 1974-77 period, the property tax component of the CPI increased at a faster rate than the all-component CPI. The reverse combination of a lower growth in provincial transfers and a higher expenditure growth at the municipal level has resulted in significantly increased property taxes. In effect, the expenditure changes and taxpayer savings at the federal and provincial levels may have been offset, in part, by increasing municipal taxes and this shows up in our statistical measure of inflation.

Any judgment about the appropriateness of the increased property taxes depends upon the value of the services provided and upon the alternative ways of financing the necessary services.

The major indicators of the increases in local government property taxes illustrate that their growth has been relatively restrained in the 1970s but that a shift in the trend developed around 1974. This situation can be described by analyzing the property tax component of the Consumer Price Index and by surveying tax patterns.

Consumer Price Index Changes



Within the Consumer Price Index, the property tax component—which represents about 10% of the various housing expenditures tracked by the



CPI—increased by only 4% from 1971 to 1974. Over the same period the total CPI went up 25% and the housing index rose about 21%.

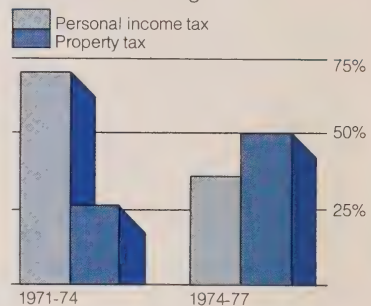
Since 1974, however, the property tax component of the CPI increased by 36% compared with the all-item CPI increase of 29% and the housing component increase of 34%.

The same situation can be observed by comparing the rates of increase of revenue from various tax sources. From 1971 to 1974, personal income tax receipts (federal and provincial) increased by 70% while there was a 28% increase in total local government property tax revenue. Since 1974, however, property tax revenue has grown 50% compared with the 36% rise in revenue from personal income tax.

There appear to be three major factors in the relatively high growth of property taxes in recent years:

- diminishing rate of growth in provincial grants to municipalities;
- a higher growth rate for municipal expenditures in the period 1974-77;
- new methods of property valuation and reassessment;

Tax Revenue Changes



Traditionally, local governments have relied primarily on property taxes for the bulk of municipal revenue. As local government services expanded, municipalities sought grant assistance from provincial governments, and in the early 70s, they got it. From 1971 to 1974 provincial grants, which represent approximately half of total local revenue, increased by 45%, whereas municipal property tax revenue increased by only 27%.

By 1975, provincial governments had begun to restrain expenditure growth. In the last two years, provincial transfers to local governments increased

by 21%, while property taxes went up nearly 30%.

Part of the increase in property taxes and the reduced growth in provincial transfers to municipalities does not impose a direct burden on taxpayers, however, because several provinces chose to introduce property tax rebate programs. These rebates involve tax credits (Ontario, Manitoba), direct ratepayer grants (Saskatchewan), or municipal assistance to enable reductions in tax levies (Alberta, British Columbia).

Despite the reduced growth of provincial grants, the municipal sector had a higher expenditure increase (50%) for the period 1974-77 than for the previous three years (39%). It should be noted that a large proportion of municipal expenditures is on education—in the order of 43% in 1977.

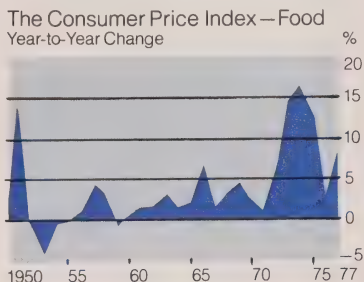
A third factor in rising property taxes relates to the phased implementation by several provinces of new methods of property valuation and reassessments. Recently, several provinces have either adopted, or are considering adopting, property valuation at market prices and annual reassessment tied to changing house prices. As house prices rise, so will taxes—without mill rate adjustments.

One very interesting side effect will have resulted from a shift of tax burden from income taxes to property taxes. While the CPI includes, as one component, a property tax index, it does not take into account either personal or corporation income taxes. Even if the over all tax level were to remain constant, a shift from one tax source (income taxes) to another (property taxes) will lead to an increase in the CPI—that is, our statistical measure of inflation will increase by a small amount in response to a reallocation among our tax measures. At present, property taxes represent about 2.85% of the total goods and services included in the CPI; a 10% increase in local property taxes in any given year would result, therefore, in an increase in the CPI of somewhat less than 0.3%. Since any increase in property taxes is entered into the CPI during one month (October), there is a "lumpiness" in the way our inflation measurement accounts for this item (except when considered on a full year-to-year basis).

## Putting food prices in perspective

Canadians have become accustomed to food prices going up with great regularity each year, yet it is only in the past six or seven years that the price of food has risen so steeply. For more than twenty years before that, with the exception of the outbreak of the Korean War in 1951, food prices were rising by an average of only 2.2% a year, when measured by the Consumer Price Index for food consumed at home.

But 1972 marked the end of relative stability of food prices. For reasons that we have explained elsewhere, prices of food commodities then became quite erratic, and food prices generally began climbing at a rate of more than 10% a year. The Consumer Price Index for food (see chart) increased by 80.1



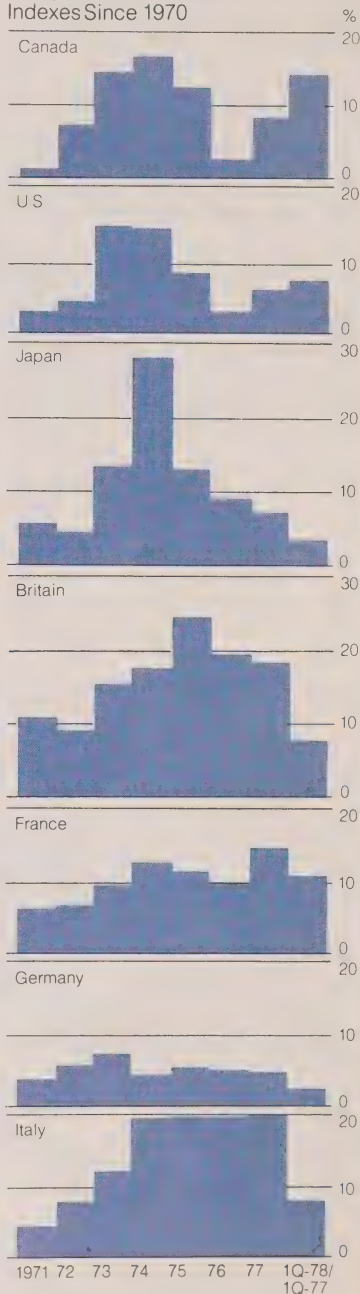
points from 1971 to 1977, an average annual increase of 10.4%, which was nearly four times the rate of increase of the preceding period.

Canada was not alone in this experience. With the exception of West Germany, which was able to hold down the rate of increase in its food prices because of the relative strength of its currency, food prices rose dramatically in all the major industrial countries between 1972 and 1975.

In 1975-76 food price increases moderated considerably in Canada and the United States and, to a lesser extent, in Japan and the U.K.. In Canada the prices of some food commodities actually went down, and the total food component of the Consumer Price Index also declined during this period.

Since 1976 food prices have again surged upward in North America in contrast to Japan and Germany and, more recently, Italy and the U.K. This divergence in price performance

Year-to-Year Changes in the Food Components of Consumer Price Indexes Since 1970



between Canada and the U.S. and their major trading partners may be attributed largely to the significant depreciation of the U.S. and Canadian dollar relative to other currencies, combined with adverse weather conditions in North America which caused poor crops.

Food price performance has varied substantially between major food commodities. The chart shows that since 1971 price increases have been greatest for fresh fruit and vegetables, fish, beverages, pork, poultry and beef.

While price increases by commodity group are important in understanding the general rise in food prices, they do not of themselves provide a very good indication of the major contributors to the increase in overall food costs, because no allowance is made for consumer preference in food. For example, while fish prices during the period 1971 to 1978 increased by 155%, this was not a major factor in increasing total food costs because per capita consumption of fish products is low in comparison with other food items. Cereal and bakery products, on the other hand, while only increasing by 98% during this period, had a much

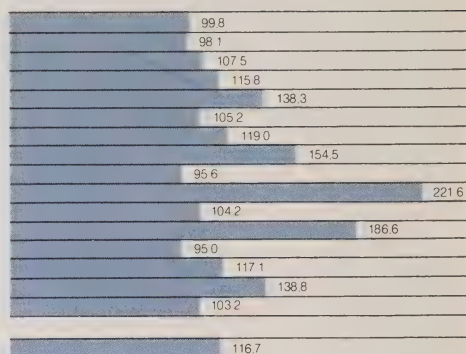
## Food Price Increases

Percentage Change August 1978/1971 Average

### Sub-Components

Dairy Products  
Cereal and Bakery  
Fats and Oils  
Beef  
Pork  
Other Meats  
Poultry  
Fish  
Eggs  
Fresh Fruits  
Processed Fruits  
Fresh Vegetables  
Processed Vegetables  
Other Food  
Beverages  
Food Eaten Away from Home

### Total Food



greater impact on total consumer expenditures on food because of the importance of these products to the average consumer.

The years 1971 to 1975 were a period of generally rising food prices, led by prices of dairy products, cereal and bakery products and sugar-based foods. Following this period of general, rapid increases in prices, the food price

performance improved significantly in 1976. The improvement was largely attributable to lower prices for beef, fats and oils, and sugar, but most other food prices increased more slowly in 1976. Beginning in 1977 the major influences on higher overall food prices have been beef, fresh fruits and vegetables, beverages and dairy products. Beef products alone accounted for more than 25% of the rise in food prices since 1976.

## Mainly because of the wheat

High food prices during the 1970s may be attributed to several different causes:

- government policies of supply management in the egg, turkey and dairy industries insulated these industries from the usual market pressures and meant higher prices for consumers.
- international market prices for some produce such as fresh fruits and vegetables and commodity agreements for certain commodities such as sugar, cocoa and coffee, affected prices in Canada.
- sharp increases in energy prices added to costs in all sectors of the food industry.
- at the processing, distribution and retail levels of the industry, higher costs for labour and packaging also played a role.

The main source of food price increases, however, has been the sharp increase in wheat prices since the abrupt turnaround of international grain markets in 1972-73. Grain is not only a basic ingredient of the human diet, but it is also the main raw material used in the production of livestock, poultry, egg and dairy products. So grain prices have a major impact on the price of food in general.

During the 1955-1970 period world grain production increased rapidly in response to technological advances, genetically improved varieties, and a series of agricultural policies that encouraged grain production through price stabilization at the international level.

In the grains and oilseeds market the major stabilizing influence during the 1950s and 1960s was the "offer to buy" program of the U.S. Commodity Credit Corporation. When prices for grains and soybeans fell below specified levels, U.S. supplies of these commodi-

ties were diverted from export markets through purchase by the CCC at support prices, creating a "floor" below which world prices did not fall to any significant degree. Since grains and oilseeds stocks were available at pre-determined price levels slightly above the support price, this also provided a price "ceiling" which stabilized international prices, albeit at a substantial cost—particularly to the United States—in terms of storage charges.

Until the end of the 1960s an additional stabilizing influence in the grains market was a series of International Wheat Agreements and International Grain Agreements negotiated between major exporting and importing countries. In Canada the federal government also attempted to stabilize prices in response to surplus build-up during the mid 1950s through enactment of the Temporary Wheat Reserves Act.

Reserve stocks of grains continued to build up through the late 1960s and

at the start of the 1969-1970 crop year had reached an unprecedented 100 million tonnes. At the same time agricultural producers were facing a cost-price squeeze as a result of relatively sharp increases in hired farm labour and machinery costs, rapidly escalating costs for energy and fertilizer, and deteriorating prices for many agricultural commodities. As a result, farm policies and programs during this period were directed at reducing surplus production and improving farm incomes.

In late 1969 in response to record storage stocks, the major wheat exporters chose to withdraw from their market agreements. In Canada the LIFT program (Lower Inventory for Tomorrow) was implemented in 1970, under which the Federal Government, through the Canadian Wheat Board, compensated producers for reducing acreage. The United States, in its Set-Aside program, also sought to reduce acreage sown to wheat. These policies in combination with continuing increases in world demand for wheat as a result of population growth, resulted in a 25% reduction in world stocks at the outset of the 1972-73 crop year.

The major turnaround in the international grains market occurred during the period 1972-73, shifting expectations of a surplus grain era for the 1970s to the reality of a world "food crisis" seemingly overnight. Poor crops in the U.S.S.R., Australia and India, together with a relatively sharp decline in world rice supplies, greatly taxed world grain reserves. The impact on previously stable international wheat prices was dramatic. Export prices for top grade Canadian spring wheat, for example, jumped from \$70 per tonne in August 1972 to over \$200 per tonne in August 1973.

While there was a modest recovery in wheat supplies during the 1973-74 crop year, poor crops in North America and India kept world stocks at a lower level, and international wheat prices remained at close to \$200 per tonne throughout much of the 1974-75 crop year.

During the period 1972-1974, international market prices for feed grains and oilseeds also increased sharply in response to a general tightening of supply and a trend in the beef industry to feeding cattle grain rather than grass. This trend had accelerated

during the 1960s when there was a surplus of grain, and it allowed beef to be finished to market weight in a much shorter period of time. Beef consumption in the developed countries of the world increased creating strong demand for feed grains. But high wheat prices had encouraged farmers to switch their feed grain acreage to wheat. These developments all pushed up feed grain prices.

In May 1974 U.S. corn at Chicago—one of the prime determinants of international feed grain prices—traded at \$2.70 per bushel, more than double price levels prevailing two years before. By early 1975 corn prices had advanced to \$3.40 per bushel. Improved crop developments during the latter half of 1975 brought prices down again to a range of \$2.50 to \$2.60 a bushel.

International soybean prices fluctuated widely during the 1972-74 period. Because soybean meal is used as a protein supplement to livestock feed, the price of this commodity has a strong influence on the price of food in general. As well, the Peruvian anchovy harvest, which is another important source of protein supplement for livestock, failed to materialize in 1972-73. World market prices for oilseeds during

the 1972-73 period rose to almost five times the price levels which prevailed in early 1972.

The current price of wheat is around \$158 a tonne, down considerably from the highs of 1974. In contrast, slaughter steer prices in Toronto are currently over \$60 a hundredweight, having been below \$40 in the summer of 1976. Even though grain prices have fallen from their 1974 peak, beef prices have been high because of the impact of high feed grain prices on beef production in the mid 1970s.

Policies which are designed to affect the movements of the price of grain are of considerable interest not only to grain growers and cattlemen, but also to consumers. Among the most important policy developments affecting the price of grain are those which regulate the international stocks of wheat. At the present time Canada along with the other major wheat producers is reviewing changes in the International Wheat Agreement. The importance of the outcome of the negotiations is clear. The long run price movements of a large number of food items will depend on the effectiveness of an agreement to reduce fluctuations in the price of grain.

## Going out to dinner

Along with sharply rising food prices over the past few years, there has been a change in the pattern of consumer spending on food. Food expenditure surveys show that Canadians spent 18.3% of their incomes on food in 1969. By 1976 that proportion had fallen to 15.6%.

Eating outside the home has apparently become more popular, perhaps as a result of changing lifestyles and more women working outside the home. The proportion of income spent on restaurant meals rose from 4.0% to 4.5% between 1969 and 1976. At the same time, the proportion of income spent on food at home dropped from 14.3% in 1969 to 11.1% in 1976.

The Consumer Price Index is now being revised to reflect these and other changes in consumer spending habits.

# Canada needs a food strategy



Against the backdrop of mounting public concern about the food and agriculture industry, several major themes emerge.

One is the need to develop a comprehensive food strategy for Canada—one that is consistent with overall social and economic objectives. Such a development should become and remain a foremost priority of government.

The benefits to consumers, farmers, and the whole food industry of a more stable market are also clear. Increased stability would enhance production decisions and contribute to greater overall efficiency.

The critical issue in the current food policy debate is not, however, whether we should pursue stabilization, but how. The nature, direction and long-term implications of policies designed to effect such a goal are vital.

Fundamental to past agricultural policy has been a concern with stabilizing producer incomes. However, in the case of agricultural supply-management marketing boards, this has been attempted through long-term policy measures aimed at stabilizing commodity prices and supply levels through administered pricing, production controls, and trade and tariff barriers to foreign competition.

There is no question that the food sector deserves the same consideration now enjoyed by other parts of the economy which benefit from govern-

ment policies and programs designed to reduce the negative effects of short-term market anomalies. Indeed, in the short term, depressed or sharply varying farm incomes resulting from market adjustments may create severe cash-flow problems, hampering efficient decision-making at the farm level.

In this situation, *temporary* income assistance (in the form of direct income subsidies or contributory income insurance programs) can be of major benefit to producers in the short run without interfering with the response to market signals that is necessary to long-term economic efficiency.

Governments may respond to what is essentially a short-term income problem for *some* producers with policies that may have an adverse long-term impact for the industry as a whole. Policies such as administered pricing schemes and tariff and non-tariff barriers to trade interfere with the price mechanism and market forces. Any immediate benefits for producers and consumers may be rapidly offset by the evolution of a high-cost, inefficient industry structure which will require *increased* market protection and subsidies to remain viable.

In the formation of a comprehensive food strategy, it will be essential to establish priorities between social and economic objectives. The policy tools appropriate for each must be considered not only on terms of their short-

term effectiveness, but how they will serve these dual objectives over a long period of time.

The federal government flagged food price inflation as a primary concern in the Throne Speech of January 4, 1973. Shortly thereafter, the Special Committee on Trends in Food Prices was struck to investigate domestic and international factors affecting food prices and to make recommendations with respect to the food industry. During its year of study the Committee pointed to the need for a long-term food policy. In the shorter term it recommended the creation of the Food Prices Review Board to investigate food price trends in Canada.

In its final report the Board recommended the formulation of a long-term national food policy as "the single most important policy adjustment required in the new circumstances facing the food sector" and urged the creation of an independent food policy review board to oversee its development. The Board also counselled the government to seek alternatives to the marketing-board system, which it claimed promoted inefficiency and market distortions to the detriment of the public interest. Neither of these proposals was pursued, and the Board was officially disbanded in October 1975 to make way for the Anti-Inflation Board (AIB).

The AIB's mandate to control wage and price increases explicitly excluded prices at the farm gate. Necessarily, then, its activities focused on ensuring that post-farm-gate price changes did not exceed allowable cost increases. Food price increases moderated slightly during the first year of the AIB's existence. But, as the agency winds down, food prices have again become extremely volatile.

In the meantime the establishment of the Centre goes some way towards answering the need for a national review body. The Centre considers the analysis of key structural and sectoral issues in *all* segments of the food and agriculture industry to be an important function of its responsibility to assess the determinants of inflation, productivity and growth performance in the Canadian economy.

# The outlook for food

## Beef

Two fairly distinct types of beef are consumed in Canada:

1. *High-quality beef*, such as steak, roasts, etc., produced largely by two sectors of the North American beef industry—the rancher or cow-calf producer (who rears a calf to a weight of 350 to 600 pounds and the feedlot operator (who buys the calf and feeds it a high grain diet until it reaches a slaughter weight of 850 to 1100 pounds). Including the time required to increase the cow herd, the lag between the production decision and the appearance of beef at retail stores is 3½ to 4 years. The price of feeder calves is determined mainly by current and expected beef prices and feed-grain prices: as feed-grain prices rise, feedlot costs increase, causing calf prices to fall, resulting in a reduction in calf production.
2. *Lower-quality beef*, used in hamburger, processed meats, canned stews, etc., is normally grass-fed (4 to 6 years in production) and supplied mainly by imports from Argentina, Australia and New Zealand, supplemented by meat produced from old beef and dairy cows in Canada and the United States.

High beef prices in 1978 have resulted from a combination of factors. The relatively low and stable grain prices through the late 1960s and early 1970s led to an increase in beef production and reasonably stable beef prices. Then in 1973-74 unanticipated sharp rises in grain prices occurred. In response the price of feeder calves dropped over 40% between 1973 and 1975 as feedlot operators, facing a severe cost-price squeeze, reduced their losses by marketing cattle at lighter weights. Ranchers, facing more severe losses, also reduced their herds, resulting in an immediate increase in beef slaughter and a corresponding decline in calf production. The ensuing increase in beef supplies in 1975-76 caused slaughter beef prices to drop. In 1977-78, with lower domestic and international cattle stocks and—towards the end of the period—declining slaughter levels, slaughter beef prices turned sharply upward, as did feeder calf prices in response to lower grain prices.

In response to these higher prices, more heifer calves were retained to rebuild the now more profitable cow herd. Feeder calf availability was reduced in the short term. The decision by feedlot operators to feed cattle for a longer period further reduced the very short-term slaughter beef supply and raised prices. Hence the sharp rise in farm-level beef prices this year.

The beef cow herd, and therefore production of feeder and slaughter cattle, will continue at lower levels over the next two to three years. Slaughter also will be reduced as herds are rebuilt. Since population and income growth over this period is predicted to expand consumer demand for beef by about 3% to 4% a year, beef prices are expected to continue to increase over the next two years.



The extent and timing of price increases will largely depend on grain markets. In the short term, if grain prices remain at lower levels, and continued feeding is profitable, cattle held off the market as a result of the strike in the beef slaughter industry in July and August will come to market over a longer period, maintaining beef prices at current levels over the next few months. If, however, grain prices were to suddenly increase this fall (due to adverse crop developments) slaughter levels would increase sharply, resulting in a temporary short-term reduction in beef prices (which, however, would rise later due to reduced supplies. In the

longer term, higher grain prices would lead to substantially higher beef prices in late 1979 and 1980; lower grain prices would moderate beef price rises.

In 1979, assuming that normal grain market prices prevail and retail margins are maintained as a constant percentage of retail prices, beef prices may average 10% to 15% higher than in 1978. Initially, these increases will appear in relatively higher prices for hamburger and other lower-priced cuts, resulting from a decrease in the supply of lower quality cow-beef and tighter supplies of this type of beef from Australia and New Zealand.

## Pork

In contrast to beef production, which has declined in the past year, hog production in Canada and the United

States has been rising since late 1976, moderating pork price increases and, indirectly, price increases for beef as well. Domestic hog slaughter, which increases seasonally in the fall, is expected to continue above year-earlier levels throughout the remainder of 1978, placing continued downward pressure on pork prices. If feed markets remain stable through 1979, hog production in Canada and the U.S. is expected to increase over the next year.

The corresponding increase in hog supplies next year would normally result in a reduction in pork prices. However, anticipated reductions in beef production over this period will increase

consumer demand for pork, likely resulting in relatively stable pork prices throughout 1979.

## Fruits and vegetables

Production uncertainties are the main factors in short-term and seasonal price swings for fruit and vegetable products, particularly fresh produce.

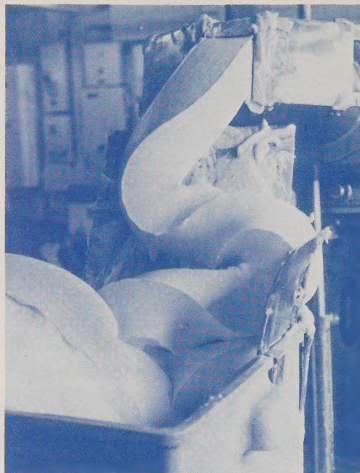
Since Canada relies on several sources of supply—California, Mexico, and Florida throughout the year, and the northern U.S. and domestic supplies in summer and fall—adverse weather in any of these areas has a dramatic effect on seasonal prices. Prices of some major horticultural commodities, such as potatoes, are also affected by year-to-year price cycles: high prices one year encourage increased production the following year, resulting in lower prices which, in turn, discourage production and increase prices in the subsequent year. Further, fresh vegetable and fruit production, distribution and retailing are relatively labor-intensive. Increasing wage rates will tend to be quickly reflected in the prices of fresh products relative to the prices of processed fruits and vegetables.

The prices of fresh fruits have risen substantially in the past year. In early 1977, fresh fruit prices reflected severe frost damage to late-grown citrus crops in Florida. Trees bearing early and mid-season crops also suffered frost damage and supplies fell below seasonal levels during the fall of 1977 and winter of 1978. High prices as a result of reduced supplies were further aggravated by the depreciation of the Canadian dollar.

In the fall of 1977 fresh vegetable prices began to rise sharply as well in response to a seasonal reduction in domestic supplies, and the depreciated Canadian dollar sustained high import prices for these commodities throughout the winter of 1977-78. Spring supplies of U.S. tomatoes, lettuce and celery were reduced by damage from rain in California and frost in Florida. By June, domestic carryover stocks of potatoes and onions were depleted, and U.S. supplies were well below normal as a result of unprecedented weather damage to spring potato crops and destruction of a high proportion of the onion crop.

While the longer-term prospects for fresh fruit and vegetable prices are

uncertain, the outlook for the next few months is relatively good. The usual seasonal price declines associated with a large late-summer and fall crop of fresh vegetable and apples is expected to place significant downward pressure on prices from recent record high levels.



## Supply—managed commodities

“Administered prices” set by marketing boards, rather than market forces, are the major determinant of prices for food produced under “supply management” programs. At present such programs apply to:

- milk (both fresh milk and industrial milk—the latter influencing prices for butter, ice cream, cheese and other processed dairy products),
- turkeys,
- eggs (both table eggs and “breaker” eggs—the latter influencing prices for products manufactured from processed egg product), and
- broiler chickens.

The marketing-board pricing formulas vary considerably among commodities. In general they are designed to ensure that prices received by producers in each province will cover the producer's cash costs, fixed investment, and overhead, and leave him some return on his production.

Since production of supply-managed commodities is regulated by marketing boards and import competition limited, to varying degrees, through the use of quotas, tariffs and non-tariff barriers, formula prices set at the farm-gate level are maintained and are

reflected in prices paid by egg grading stations, poultry processors and dairies for these products which, in turn, effect price movements at the retail level.

## Dairy products

“Fluid” or fresh milk production in Canada is administered by provincial milk marketing boards. Production of industrial milk falls under federal jurisdiction through the Canadian Dairy Commission. In both markets, government policy has a strong influence on consumer prices.

Last January the federal agency raised the *target returns level* for industrial milk by 2.7% and increased support prices for butter and skim milk powder by two cents per pound (to \$1.22 and 72 cents, respectively). In mid-April the target returns level was again raised 2%, and the support prices for butter and skim milk powder were also raised to \$1.27 and 74 cents. The result was a sharp increase in consumer prices for dairy products during the spring and early summer.

This was compounded by the government's March 31 withdrawal of the 34-cent-per-pound consumer subsidy on skim milk powder. By July retail prices for skim milk powder averaged 52% more than at the start of the year.

While farm prices for fresh milk increased this year in all provinces except Saskatchewan and Ontario, the increase in the CPI for fresh milk has not been as great as for dairy products.

Given recent CPI increases and their effect on the dairy returns adjustment formula, it is likely that the federal government will soon increase the target returns for industrial milk, probably before January. If Ontario and several other provinces also increase farm prices for fluid milk, an increase in prices paid by consumers for dairy products by early January 1979 of approximately 2% is anticipated.

## Poultry

Retail poultry prices increased by about 18% last year, reflecting strong demand created by higher prices for red meat. Throughout the first half of 1978, demand for poultry meat outstripped domestic supplies, and depreciation of the Canadian dollar further raised the

price of imported poultry. By June domestic storage stocks of chicken had fallen to the lowest level in more than a decade, and remained low throughout the summer.

Some improvement in supplies may now occur as a result of increased production in both Canada and the United States. This fact, coupled with a normal seasonal drop in consumer demand in the fall, should result in slightly lower poultry prices through the remainder of this year. What happens after that will depend on the prices of red meats and poultry feed. Since beef prices will likely continue to rise in 1979, correspondingly increased demand for poultry products and relatively stable feed costs would indicate continued expansion in poultry production. This points to relatively stable prices next year.

## Eggs

During the past year, retail prices of eggs in Canada were extremely stable increasing by only a penny a dozen on average.

In July 1976, facing a general tightening of supplies, the Canadian Egg Marketing Agency authorized a 5% increase in production quotas. But either the shortage was over-estimated or the production response was underestimated, because by the fall of 1977 CEMA was faced with a rapidly growing egg surplus.

The results were a huge increase in cut-rate egg exports, a drop in producer prices and a production cutback ordered by the Agency on January 1, 1978. Due to production lags, the impact of the latest cutback should begin to be felt over the next few months, and supply will be closer to demand.

Seasonal price declines in the grains market this fall should be reflected in lower consumer egg prices, although this may be partially offset by higher unit costs associated with lower production levels.

## Sugar

Since 1974, when sugar prices went above 60 cents per pound on international commodity markets, prices have fallen steadily and over the past two years have ranged between 6 and 10 cents per pound. The latter prices are well below production costs (even in the most efficient producing countries) and could discourage production over the next few years leading eventually to a sharp rise in prices.

In an attempt to avoid this, a new International Sugar Agreement is being considered to stabilize prices at between 11 and 21 cents per pound. Under the agreement, market supplies would be regulated by the use of export quotas and the creation of reserve supply stocks (buffer stocks)—financed by a levy of 0.25 cents a pound paid by exporting and importing countries.

In January 1978 the pact became provisionally operative, with agreement by more than half the members of the International Sugar Organization. Establishment of a fund and the collection of levies to finance surplus stocks was scheduled to become effective on July 1, but that move was postponed to October 1. The deadline for ratifying the new agreement was also postponed to December 31, to allow importing countries time to pass legislation approving the agreement. These delays have exacerbated the effects of low world sugar prices in recent months and, unless the agreement is ratified at the end of the year, sugar prices could remain depressed through 1979. If the U.S. ratifies the agreement, sugar prices could begin to move up next year, although stabilization of international sugar markets may require considerable time.

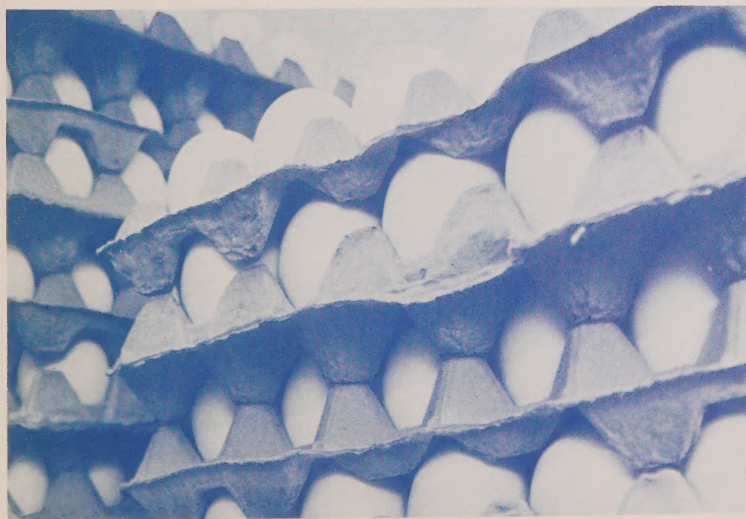
## Beyond the farm gate

About 60 cents of the consumer's food dollar goes to the food processing, distribution and retailing sectors. But since their combined profits account for only two or three cents of the retail food dollar, profits in this sector have a small effect on final food prices to consumers.

Costs in this business have a much greater effect on final selling prices—costs of raw materials, labour, energy, packaging and transportation. These in turn are affected in part by the structural and organizational conditions in the industry—the degree of market competition, and such factors as the rate of capacity utilization, investment, technological adaptation, and production efficiency.

An Anti-Inflation Board study on price spreads and profit margins at the processing, distribution and retail levels is scheduled for release this month. It should provide an initial assessment of market performance in the food industry beyond the farm gate.

We expect food prices on average to show little or no increase for the rest of 1978. But because of price increases which have already taken place, the consumer price index will end the year at least 12% above December 1977. We expect food price increases to moderate considerably next year.





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